

# SUMMARY

- 1.1 This paper sets out the Law Commission's and the Scottish Law Commission's preliminary thinking on reforming the law of insurable interest. We put forward some initial, tentative proposals, and seek views by **11 April 2008**. Details about how to respond are at page 1 of the paper.

## THE CURRENT LAW

### What is insurable interest?

- 1.2 The law states that in order for an insurance policy to be valid, the policyholder must have a sufficient interest in the subject matter of the insurance. Broadly speaking, the doctrine requires that a policyholder must gain a benefit from the preservation of the subject matter of the insurance or suffer a disadvantage should it be lost.
- 1.3 The rules are complex. They date back to the eighteenth century, and are imposed partly by statute and partly by the common law. The legislation is not always consistent, so it is often difficult to work out the present position. There are differences between types of insurance, and between English and Scots law.

### The distinction between indemnity and non-indemnity insurance

- 1.4 The law differs between indemnity and "non-indemnity" insurance (also described as "contingency" or "valued" policies). In indemnity policies, the insured may only recover the amount they have lost (the "indemnity principle"). In "non-indemnity" policies the insured receives a set amount, following a trigger event. Liability and property insurance are examples of indemnity insurance. Life insurance, personal accident and critical illness policies are examples of non-indemnity insurance.
- 1.5 The rules on insurable interest are much stricter for life insurance and other non-indemnity insurance than for indemnity insurance. Generally, for non-indemnity contracts there must be an insurable interest at the inception of the policy. For indemnity insurance the situation is more complicated.
- 1.6 In Part 3 we set out the law on non-indemnity insurance. In Part 5 we discuss the law on indemnity insurance. A brief summary is given below but for a full discussion of the law readers are encouraged to read the paper.

### Life insurance

- 1.7 In this paper, we use "life insurance" as a shorthand for life insurance and other policies (such as accident and critical illness policies) that pay a set amount following death, injury or illness.
- 1.8 Policyholders may take out unlimited insurance on their own lives, or on the life of a spouse or civil partner. However, the law does not recognise other classes of natural affection. For example, parents have no insurable interest in the lives of their children and, in England, children have no interest in the lives of their parents. Nor do cohabitants have a general right to insure each other's lives.

- 1.9 Where life insurance is taken out on the life of someone who is not the policyholder or their spouse, the policyholder must show “a pecuniary interest recognised by law”. Here the amount of the insurance must not exceed the value of the interest. This allows joint debtors to take out life insurance on each other’s lives, for example to protect a mortgage, but the value of the payment must not exceed the amount of the debt. It also allows employers to insure the lives of employees, but case law suggests that the amount must be limited, possibly to no more than the employee’s value during their notice period.

#### **Other non-indemnity insurance**

- 1.10 It is theoretically possible for non-indemnity (that is, valued) policies to be taken out on property. These would pay a set amount on damage to the property regardless of the policyholder’s loss. An example would be a contract that paid a sum of £100,000 if a property were destroyed by fire, regardless of the amount of loss. These are unusual products and the law in this area is particularly unclear.
- 1.11 Under Scots law there is a common law requirement for the policyholder to show insurable interest. Under English law, there may be a requirement for the policyholder to show an insurable interest for marine policies or for those on land or buildings. The position for other policies is unclear. These insurance contracts would bear similarities to credit derivatives if there were no requirement for insurable interest.

#### **Indemnity insurance**

- 1.12 The law on insurable interest in indemnity contracts is also confusing. Before the Gambling Act 2005, the law required that anyone taking out property insurance had a legal or equitable interest in the property or a right to it under a contract. Without that interest, the insurance contract became unenforceable and policyholders could not have claims paid under it. In England, this requirement for insurable interest appears to have been removed by the Gambling Act 2005, though the change may have been more by accident than design. It would seem that under English law indemnity insurance contracts without insurable interest are now enforceable.
- 1.13 However, under Scots law, the requirement remains: the policyholder must show a pecuniary interest in the subject matter of the insurance at the time of inception.

#### **PROBLEMS WITH THE LAW**

- 1.14 The law on insurable interest is complex and we have often found it difficult to analyse. This makes it difficult for both insurers and policyholders to understand and apply the law.
- 1.15 For life insurance, the rules appear overly restrictive. In particular:
- (1) Cohabitants and other family members may find it difficult to obtain insurance on each other’s lives. Parents who, for example, are dependent on their adult children paying their nursing home fees may find it difficult to insure the lives of those adult children.

- (2) Some of the problems are currently solved using assignment. For example, children may take out policies on their own life and assign them to their dependent parents. However, this adds an unnecessary level of complexity.
  - (3) Employers may be unduly limited in the amount for which they may insure the lives of their key-employees.
  - (4) Interest payable on an open-ended debt may not be insurable, because the liability did not exist at the time of inception.
  - (5) The Life Assurance Act 1774 requires that the names of all interested parties are listed in the policy. This can make policies illegal on a technicality.
  - (6) The insurable interest that is necessary for policies of group insurance is particularly difficult to analyse.
- 1.16 For non-life, non-indemnity insurance, the current uncertainty as to the state of the law may reduce insurers' confidence in offering new products.
- 1.17 There are also problems with indemnity insurance:
- (1) The impact of the Gambling Act 2005 on indemnity insurance is unclear and was not considered when that Act was passed. Now that the Act is in force, it appears that under English law most contracts of indemnity insurance without insurable interest are valid but those made under Scots law are not.
  - (2) Archaic statutes may trip up the unwary. For example, it remains a criminal offence to take out a contract of marine insurance without interest.
- 1.18 More detail on these problems can be found in Part 4 (non-indemnity insurance) and Part 6 (indemnity insurance) of this Issues Paper.

### **DO WE NEED A DOCTRINE OF INSURABLE INTEREST AT ALL?**

- 1.19 The doctrine is said to serve two purposes: to define insurance and to prevent undesirable social effects.

#### **Defining insurance**

- 1.20 Different regulatory and tax regimes apply to insurance than to other commercial risk transfer products or to gambling. It is therefore often necessary to distinguish insurance from (for example) credit derivatives or betting. We therefore consider whether insurable interest is necessary to distinguish insurance.
- 1.21 In Part 7, we discuss the different ways that insurance is defined. Although most definitions require that the insurable event has some adverse consequence for the insured, this is different from the much narrower statutory and common law concepts of insurable interest.

- 1.22 We conclude that indemnity insurance can be distinguished from betting and other risk transfer products without preserving the doctrine of insurable interest.

### **Undesirable gambling and moral hazard**

- 1.23 As we discuss in Part 2, insurable interest has also been used as an instrument of social policy. Before the Gambling Act 2005, all forms of gambling were considered undesirable, but some forms were thought to be particularly pernicious. Thus the Life Assurance Act 1774 described taking out insurance on the lives of strangers as “a mischievous kind of gaming”, which might encourage murder.
- 1.24 Now that gambling contracts are legally enforceable, we have considered whether it remains necessary to prevent insurance on the lives of strangers. The law can only go so far to prevent moral hazard: it is, for example, possible to retain an insurance policy on a divorced spouse, and the traded endowment policies market allow people to benefit from insurance on the lives of strangers. There is an argument that the issue should be left to the market, so that insurers are responsible for not issuing policies which encourage moral hazard. The Australians have taken this approach, and abolished the doctrine of insurable interest altogether.
- 1.25 However, other jurisdictions have not been as bold as the Australians. Initial consultation suggested that there were real concerns about allowing people to insure the lives of strangers without their consent. For example, a market in insurance on the lives of celebrities would be distasteful – and might, possibly, be dangerous.
- 1.26 We would be interested to hear views on this issue. Our preliminary view is that the doctrine of insurable interest in life insurance should be retained. However, the categories of interest should be expanded, giving more people rights to insure the lives of others.
- 1.27 In relation to indemnity insurance, the issues of moral hazard and gambling in the guise of insurance are less important. This is because the indemnity principle also applies to indemnity insurance contracts and it already contains safeguards against moral hazard and gambling in the guise of insurance.
- 1.28 The indemnity principle requires the policyholder to have suffered a loss before a claim can be made. Policyholders will only suffer a loss if they have a connection to the subject matter of the contract. A company, for example, cannot claim for the destruction of a van it has not lost and therefore the company is already prevented insofar as is possible from deliberately destroying the van or gambling without any interest in its destruction. As the indemnity principle already guards against moral hazard and gambling in indemnity insurance contracts we have tentatively concluded that insurable interest in indemnity insurance, with all its complexities and legal requirements, is unnecessary.

### **WHAT REFORMS ARE WE PROPOSING?**

- 1.29 Our tentative proposals are discussed in Part 7 and listed in Part 8.

## **Life insurance**

### ***Natural affection***

- 1.30 We think the category of insurable interest based on natural affection should be increased. In particular, people should be allowed to insure the life of a cohabitant. Dependent children and parents should be able to insure each other's lives. The law should not set any limits on the amount of the insurance.
- 1.31 We ask what should be done about other relationships. In particular, we would also be interested in whether to permit unlimited rights to insure the lives of fiancé(e)s, siblings, grandparents or grandchildren.

### ***Legal pecuniary loss***

- 1.32 We suggest that the category of insurable interest supported by a legal pecuniary loss should be amended to enable insurance to be more readily available. We tentatively propose that insurance should be allowed where the policyholder has a reasonable expectation of pecuniary or economic loss on the death of the life insured. This would extend further than the current limited test, which requires a pecuniary interest recognised by law.
- 1.33 It would mean that the insured could buy cover to meet reasonable future expenses, such as interest payments on a debt and on the loss of business which would be suffered following the departure of a key employee.

### ***Consent***

- 1.34 We tentatively propose that the consent of the life insured should provide an alternative ground for establishing insurable interest. This will give the system flexibility and the consent provides a safeguard against the creation of a moral hazard.
- 1.35 We propose that for the category of insurable interest established by consent, the amount insured should be limited to the amount to which the life insured consents.

### ***Group insurance***

- 1.36 Group insurance proved particularly difficult to analyse and insurers have told us that the current law can prevent them from offering insurance in circumstances where it could be beneficial. We therefore ask whether it would assist in the provision of policies both to employees and their wider families if the rules on insurable interest for group insurance were further relaxed. This issue is discussed further at paragraphs 3.61 and 7.81 to 7.86.

### ***The Life Assurance Act 1774, section 2***

- 1.37 This section requires the names of all interested parties to be listed in the life policy. This can serve as an unnecessary technicality. We tentatively propose that it should be repealed.

### ***Remedies for life insurance without sufficient insurable interest***

- 1.38 In most cases where insurance contracts are made without interest, this is an oversight. The policyholder has bought the wrong type of policy. One example is where insurance intended to cover a liability on a death has been written as a life policy rather than a liability policy.
- 1.39 Thus the consequences of making insurance policies without insurable interest should not be overly harsh. We propose that where a contract is made without the necessary insurable interest it should be void rather than illegal. In the absence of fraud, we would expect that policyholders should have their premiums returned.

### **Non-life, non-indemnity policies**

- 1.40 It is theoretically possible for valued (that is non-indemnity) policies to be taken out on property. These insurance contracts would bear similarities to credit derivatives if there were no requirement for insurable interest. We ask whether insurable interest is still necessary for these insurance products or whether there is any need for relaxation of the rules on insurable interest in this market.

### **Indemnity insurance**

#### ***England***

- 1.41 In England, case law and the Gambling Act 2005 appear to have abolished the requirement of insurable interest in indemnity insurance. However, the indemnity principle requires the policyholder to have suffered a loss. We think this is sufficient to distinguish insurance from gambling and to prevent moral hazard.
- 1.42 Our tentative view is that it would be difficult to justify reintroducing a statutory requirement for insurable interest for indemnity contracts. This could lead to renewed confusion and would bring little benefit.
- 1.43 We also tentatively propose abolishing the criminal penalties imposed by the Marine Insurance (Gambling Policies) Act 1909 for making a marine policy without insurable interest.
- 1.44 We also ask whether there should be a requirement on insurers to inquire whether there is sufficient possibility of indemnity loss before the contract is made. Most, we understand, would do this already for underwriting purposes.

#### ***Scotland***

- 1.45 In Scots law, insurable interest is a common law requirement and it is unlikely that it has been abrogated by the Gambling Act 2005. However, as in England and Wales, the indemnity principle applies too.
- 1.46 Our tentative view is that the requirement of insurable interest in Scots law should be abolished in so far as it applies to indemnity insurance. We would particularly welcome views on this issue from Scottish respondents.